Artzi Hiba Elmekiesse Cohen
TAX SOLUTIONS Ltd.

Tax News Alert

7 Menahem Begin st., Ramat-Gan 5268102, Israel.
Phone: 972-3-6134111. Fax: 972-3-6133113

16 Pal Yam Av. Haifa 3309523, Israel.
Phone: 972-4-9118181. Fax: 972-4-9118188

Web site: www.ahec-tax.co.il
E-mail: ahec@ahec-tax.co.il

March 27, 2018
Tax News Alert No. 29

Dear Friends and Clients
We are pleased to update you with selected Israeli tax developments for the first quarter of 2018

•

**Selected Issues:**

- A new procedure for voluntary disclosure – probably the last chance
- A last-minute declaration of the Tax Authority's position on taxation of "virtual currencies"
- Sale by a new immigrant or returning resident of shares in a foreign company, part of whose value is derived from Israeli assets
- Business investments – insight from taxation decisions on the subject of permanent establishment for foreign investors

Sincerely,
Artzi, Hiba, Elmekiesse, Cohen - Tax Solutions Ltd.

# Tax News Alert No.29 - March 2018

*Dear friends,*

The Artzi, Hiba, Elmekiesse, Cohen - firm is committed to the highest level of services. We keep our clients and colleagues, in Israel and abroad, fully up to date with respect to recent developments in the Israeli tax law and their implications.

We would like to thank you for using our services and for your kind cooperation which enables us to offer you high level tax solutions. It would be our professional, as well as our personal honor to continue cooperating with you.

## *A new procedure for voluntary disclosure - probably the last chance*

On and off and in various incarnations since 2005, taxpayers have been able to come forward to the Israel Tax Authority to settle and disclose data on hidden income and assets not previously reported as required by law. **This arrangement granted taxpayers a "clean bill of health" in the form of immunity from criminal proceedings against them.**

The most recent voluntary disclosure procedure (VDP) expired at the end of 2016. After talks with the State Attorney office, a new VDP was published in December 2017 - as a two-year (2018-2019) temporary order, **or, for anonymous submissions - for one year (2018) only. This temporary order is intended to provide citizens with a last opportunity to come forward about their income and assets, before all agreements for information exchange based on the European (CRS) and American (FATCA) initiatives are implemented in practice. Based on these agreements, information and data on income and assets held abroad by Israelis is already being delivered from the United States, and in short order from many other countries. The VDP applies to any form of unreported income and assets, not only those held abroad.**

**Conditions of the procedure** are the same as in the past, namely - that the application to the Tax Authority must be submitted honestly, completely and in good faith, and that the Authority does

not hold prior knowledge and/or that there is no inquiry or investigation of the applicant and their immediate circle by the Authority. The greatest advantage of the VDP is the ability to submit the application to the Authority anonymously; only after the expected tax liability for the specific case is clarified with the income tax assessing office must the taxpayer's identity and details be specified. Keep in mind that the **anonymous submission track of this temporary order is for one year only - that is, until December 31, 2018**, and a draft agreement must be reached within 180 days (which may be extended by an additional 90 days). The procedure also includes a shortened track for smaller amounts in which the total capital to be settled does not exceed 2 million NIS (about 570,000 US dollars) and the taxable income derived from this capital does not exceed 0.5 million NIS (about 140,000 US dollars).

**Note**: Immunity from criminal indictment is not granted to anyone whose income derives from illegal activity, and the Tax Authority will not grant immunity to anyone whose application is not submitted completely and in good faith, or that does not pay the agreed-upon taxes. A taxpayer who has benefited from the VDP in the past is not eligible to do so again. We recommend not to leave matters unresolved.

In addition to the above and to the procedure announcement, the Tax Authority has published detailed instructions for carrying out the procedure. It seems to us that the Tax Authority has retracted from its original intent to encourage Israelis with unreported income and capital to carry out the VDP and pay owed taxes thereby avoiding criminal proceedings. After reviewing the instructions, we have found that these make execution of the VDP much more difficult to carry out. Below is a brief description of some of the instructions that may pose problems for our clients and their representatives:

- **Recommendation that representatives sign a declaration on client assets and income** – for first time the VDP has requested that the client representative sign a detailed declaration, "in order to shorten and streamline the handling of the request... and to spare some of the inquiries to be carried out by the tax inspector." For the sake of "sparing inquiries by the tax inspector", an onerous burden of responsibility is being placed on the shoulders of the representatives; any erroneous or deceptive information submitted by the client may result in the Tax Authority placing the responsibility for the given declaration on the representative. **The public outcry and objections brought to the Tax Authority by the**

community has resulted in the elimination of this injunction.

- **Requirement to submit "all information and supporting documents" with the VDP application** - the procedure requires submission of "all information and supporting documents, with emphasis on the source of the principal and date of production...". Of course submission of "all" data and supporting documents is impossible - the disclosure may span dozens of years and two or three generations, during the course of which no paper trail of the capital may be available, and the origin of the principal may be unknown.
- **Imposition of a monetary sanction for lateness in report submission and deficiency fine** - throughout the talks on voluntary disclosure, the matter of fines barely came up, and only did when the tax inspector was using aggressive bargaining tactics. The new procedure includes fines as a realistic (although not required) option, with the qualification whereby a deficiency fine will not be imposed together with the monetary sanction, along with a list of guidelines for leniency - we hereby would like to "thank" the Authority for the good grace of not imposing "double fines".
- **No tax will be imposed on the principal if its source was not taxable** - the procedure stipulates that in the event that the tax assessor is convinced that the source of the capital is not taxable, no tax will be imposed on the principal. It also states, for example, that "bequests or gifts" are not taxable. Note that this is the law in effect today, and despite what is stated, the principal is still partially taxed. Time will tell whether this provision will ultimately be implemented by the income tax assessing offices.

In recent years, our office has been helping many clients - individuals, companies and trusts - to settle the affairs of their income and assets with a professional staff comprising former Tax Authority key-employees who in their previous positions also handled these very requests. We will be happy to provide assistance with any question that may arise.

## *A last-minute declaration of the Tax Authority's position on taxation of "virtual currencies"*

The Income Tax Ordinance stipulates the taxpayers obligations to report in their tax return whether they have taken a "reportable tax position". The Tax Authority has added a position entitled "taxation of virtual currencies" to that list.

The Tax Authority indicates there that

Bitcoin, Ethereum and others "virtual currencies" are defined as "assets" and therefore their sale is subject to capital gains taxes. **In the same breath, however, the Tax Authority has indicated that if those sales reach "business" proportions they are subject to taxes imposed on all business income, that is - regular tax rates** which at higher brackets may pass the 50% mark (including the surtax).

The Authority has further stated in the position that "virtual currency" "is not foreign currency and therefore an increase in its value is not to be considered 'linkage differentials' or 'exchange rate differentials' " (the provisions of the Tax Ordinance stipulate that differentials of linkage or exchange rate are tax exempt by individuals).

Our office has been advising many clients in recent months on issues related to digital currencies;

questions that have come up regarding their taxation include the following:

- selling of cryptocoins by someone who had purchased them previously.
- selling of cryptocoins obtained by 'mining' (a computational operation for creating new cryptocoins).
- selling by someone who obtained cryptocoins by exchange or by initial coin offering (ICO).
- selling by someone who obtained cryptocoins in exchange for services or product sales.
- selling of cryptocoins created by a split from an existing cryptocoin (such as Bitcoin Gold or Bitcoin Cash).

We will not analyze all the tax events presented above nor expand upon them; however, we will present the central points on the subject:

**Classification of the sales as a "business"** – The definition of income from a business (or from a "commercial nature" casual transaction) has been addressed in rulings many times over; in short – it suffices for a person to carry out a number of acquisitions and sales, and to participate in initial coin offerings (ICO), for example, in order for the Tax Authority to claim that the corresponding income derives from "a business". The nebulous term "casual transaction" which is of a commercial nature will also drag along with it similar taxation – income classified as such is subject to full taxation! Our position is that the criteria that have been determined in previous rulings are not necessarily appropriate for the considering the definition of "business" with respect to virtual currencies.

**"Virtual currency" may be claimed to be foreign currency!** We would like to state here at the outset – the Tax Authority's stubborn insistence on this matter stems from one main reason, and that is the exemption for individuals on exchange rate differential.

If not for that exemption, the Authority would not be so eager to claim that virtual currency is not considered foreign currency. We present several arguments supporting our claim that the issue at hand is actually foreign currency and exchange rate differentials:

- The definition of foreign currency as indicated in the Bank of Israel Law referred to by the Authority as reinforcement for its position is not the only interpretation that may be applied, as there is no explicit reference to that law in the Income Tax Ordinance. **Even if we use the definition as specified in the Bank of Israel Law, it is still clear that the term "banknotes or coins" does not only refer to "currency" in its physical form.** "Physical" currency – banknotes or coins – are only a small percentage of the total aggregate of cash that exists; it also includes current accounts, bank deposits, etc. Although the dollar, the euro, and other known currencies do not fit the precise definition of "foreign currency" (banknotes or coins), there is no question that exchange rate differentials do accrue in a foreign currency deposit held at a bank.
- If it's used as currency and is accepted as currency – it's currency – bitcoins along with the other digital currencies serve for all intents and purposes as currency. Hundreds of thousands of businesses worldwide provide products and services today in exchange for bitcoin. Digital currencies trading is extremely active – **on the order of a billion dollars a day** – both within the digital currencies and in exchange for regular currencies ("fiat currency"). Exchange rates for all of these currencies can easily be found in the financial media.

**These reasons and many more lead to the conclusion that digital currencies are in fact "currencies".** Many countries have recognized digital currency – bitcoin is recognized in Japan as a method of payment and nearly 300,000 business accept payment of this form; the German Federal Ministry of Finance has recognized bitcoin as a "unit of account" ("Der Spiegel, August 20, 2013); in Italy sale of bitcoin is classified as any other foreign currency business transaction with regard to VAT; virtual currency in Belarus has been granted legal status. Adoption of virtual currency as money by many countries, with currency based on blockchain technology (the technology at the basis of the bitcoin) to be issued by the central banks (including the Bank of Israel), seems to be just around the corner.

**Tax settlements with the Tax Authority for clients engaging in virtual currency**: A voluntary disclosure procedure (VDP) was published in December 2017 as a

temporary order.

The procedure allows for anonymous submissions to the Tax Authority for one year only, during which time negotiations on tax liability take place.

**The combination of VDP with the burgeoning market of digital currencies - which includes cash-outs, participation in trade and ICOs - is an excellent opportunity to settle cases that have thus far been "under the radar".**

In our experience, many clients are now finding themselves in a situation in which a small investment in Bitcoin several years ago has multiplied over the years - and must now be settled with the Authority.

In addition, we believe that the Authority will begin to actively hunt down those investors, similar to their aggressive efforts against unreported offshore bank account holders, by and large due to the completely transparent nature of blockchain technology which allows tracking of every past transaction.

## *Sale by a new immigrant or returning resident of shares in a foreign company, part of whose value is derived from Israeli assets*

As part of the list of reportable tax positions published by the Tax Authority, a position has been added on the sale by an individual who immigrated to Israel either for the first time or after a period of 10 years or more (such a "beneficiary individual" has a 10-year exemption from tax and reporting on assets and income from outside of Israel), of shares in a foreign company which holds at the time of the sale an Israeli asset, either directly or indirectly, that constitutes the essential part of its value. Thus, and according to the position, that beneficiary individual is considered to not be selling a foreign asset and will thus not be eligible for the exemption from capital gains tax, based on the rationale of the law that stipulates that sale of a foreign asset that is in essence a right to an asset or property located in Israel, shall be considered as a capital gain produced or accrued in Israel.

The clause referred to by the position asserts that a capital gain shall be viewed as produced or accrued in Israel in the event of the sale of "a right in a foreign resident body of persons, which in essence is the owner of a direct or indirect right to property located in Israel, in respect of that part of the consideration that stems from the property located in Israel"; that is, the remaining portion of the consideration is not taxable in Israel at all. For some reason, the underscored text (not so in the source) was omitted in the Authority's phrasing of the position, and we believe that it is very significant in its implementation. Take for example the beneficiary individual who holds rights in a foreign company for the first time after immigrating/returning to Israel, where the essence of its value is

produced by assets in Israel (and thus is not eligible for exemption in the sale of the securities).

According to the position, when selling the holdings in the company, there will be a tax liability on all the accrued capital gains. But at the same time, the exemption clause does not stipulate any exceptions to the exemption on the sale of shares of a foreign company by a beneficiary individual, because in any event, by the "source rule" of capital gains, only the portion of the consideration that is attributed to the Israeli asset is taxable, and not the entire consideration.

Furthermore, a beneficiary individual could claim a tax exemption by the authority of the provisions of the tax treaty between the State of Israel and the country of residence of the company being sold, because of the rule whereby the provisions of the treaty take precedence over the provisions of internal law.

## *Business investments - insight from taxation decisions on the subject of permanent establishment for foreign investors*

Many entrepreneurs wish to direct their available capital to investment in Israeli companies in a variety of areas, in particular - the Israeli high-tech sector, known to be one of the central growth engines of the economy. Government grants and the enactment of the "Angels Law" and its recent amendment are just two examples of a wide variety of government incentives for those investments.

These investors are (generally) not novices who blindly invest their money without prior scrutiny; they typically engage advisors to identify potential deals, examine the financial feasibility of the company under consideration, perform due diligence and determine the best means of investment. Sometimes decisions to move forward with the investment are made by the advisors in cooperation with the investor (including in "investment committees"). Further on, investors may appoint such an advisor as their representative to the Board of Directors of the company in which they are investing, because such investors wish to be actively involved in guiding the company's strategic business decisions in order to increase its profits. These are typical activities of all rational strategic investors of a particular company, who tend to hold on to those investments for quite a number of years.

**An interesting taxation decision (tax ruling) published recently by the Israeli Tax Authority, stipulates that such a circle of advisors may classify the profits in a future sale of the shareholdings - as taxable profits from a business, rather than exempt capital gains!** This taxation decision applies to

investments in Israel by a foreign company which uses the services of a local management and advisory team. It stipulates that **the investments of the foreign company in Israel and its accompanying activities establish a permanent establishment in Israel** (which requires corporate tax or marginal tax rates, whichever appropriate, on its income). The method of allocation of taxable income of the permanent establishment is determined by costs (worker salary and service providers, general and administrative, et al) as per the ratio of their disbursement abroad versus locally in Israel ("the allocation mechanism").

In certain cases the position at the basis of this taxation decision may in fact be advantageous for the taxpayer – as interest and dividends are obtained by the investors from their investment, these too are to be classified as a part of the business income of the permanent establishment and are thus also subject to the allocation mechanism. Thus, if the cost ratio indicates 90% abroad, for example, then only 10% of the interest and dividends obtained would be taxable in Israel. Nonetheless, the taxation decision agreed upon between the sides stipulates that all interest and dividend income is taxable in Israel; however from our stance it follows that this understanding contradicts the basis for the taxation decision – that is, the allocation of income to a permanent establishment in Israel (by the way, standard tax treaties also stipulate that taxation clauses that apply to interest and dividends shall not apply to income of a permanent establishment, as in that case the clause of business profits would apply, including implementation of the allocation mechanism).

The Tax Authority has been grappling with this issue of characterizing the class of income by investment funds – both small and large – for many years, and in practice, "qualified" investment funds have been granted benefits in the form of full exemption for cash-out and low rates on interest and dividends, both for venture capital funds and for private equity funds. For funds without a broad distribution of investors (with the limit generally set at 10 investors), and in this case – a single investor, it is indicated in the taxation decision that this approach is in lieu of a low tax rate track (in general between 10 and 15 percent). **We maintain that in these cases, Israeli law is to be interpreted in its most liberal sense, with income from cashing out of investments by small funds, foreign investors and Israeli entrepreneurs to be classified as capital gains and not as business profits.** Such an interpretation would encourage more investment in Israeli start-ups and would align with corresponding government goals (or at least would not hinder the volume of investment), would deem determination of relative costs unnecessary (after all, the tax assessor's ability to inquire and control expenses abroad and their

correspondence to Israeli investments is limited), and would allow full taxation of interest and dividends (subordinate to the provisions of the tax treaty), without the need to invoke the allocation mechanism described above.

**For the sake of comparison, note that according to the Tax Authority's policy regarding foreign hedge funds, which execute hundreds and thousands of buy and sell securities transactions annually, income from those sales is classified as exempt capital gains.**

---

In case you have any questions or need further clarifications, please do not hesitate to contact our International Taxation Team:

CPA. Ran Artzi, Managing Partner (artzi@ahec-tax.co.il)
Advocate and CPA. Hagi Elmekiesse (hagi@ahec-tax.co.il)
Advocate and CPA. Gadi Alimi (alimi@ahec-tax.co.il)
CPA. (LLB) Eyal Sando (sando@ahec-tax.co.il)
CPA. Yossi Shalom (yossi@ahec-tax.co.il)
Advocate. Danny Fink (dan@ahec-tax.co.il)